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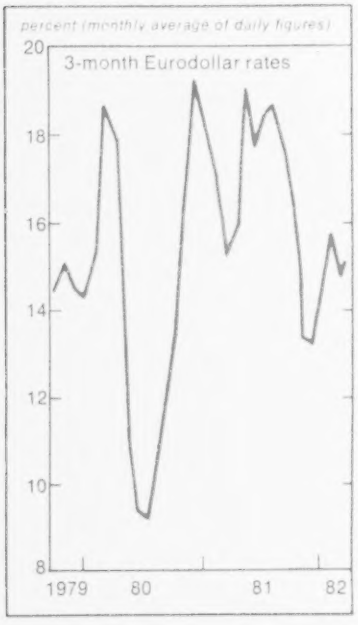
Interest Rates And the U.S. Recovery

Now that the widely heralded April bulge in the U.S. money supply is past, the greatest source of uncertainty as to future short-term U.S. interest rates is the timing and magnitude of the economic upturn. Simplifying somewhat, two scenarios seem possible. In the first of these—and the one the market appears to judge most likely—the economy is now very close to its trough and is about to move into a period of slow recovery. In this instance, short-term interest rates should drift downward over the next two to four months before bottoming out; although, if the pace of recovery should prove to be stronger than is now anticipated, this downward movement would be reversed later this summer, with rates possibly retreating back to today's levels.

Two likely developments are key to this projection: First, the present battered state of corporate balance sheets argues for both a slow rate of inventory rebuilding and a decline in business credit demand in the initial phase of the recovery period. As the level of economic activity increases and cash flow improves, credit markets will be gradually relieved of the present credit demands by businesses to finance inventories and operating costs. Second, the demand for money is unlikely to be strong enough to work against falling short-term interest rates. Although the transactions demand for money will grow as the economy changes directions, the money balances that have been built up as a precaution against a further decline in the economy will begin to unwind.

Short-term interest-rate movements



A second recovery scenario is based on the assumption that the currently high level of real interest rates delays the U.S. economic revival by a quarter or more. Under these circumstances the corporate credit demands for inventory funding, operating costs, and refinancing a growing debt burden would increase in the near term, keeping upward pressure on rates. In addition, a further buildup in precautionary money balances could occur. Both credit and money-demand factors would thus work to keep short-term rates close to present levels for a period, but the stage would then be set for a dramatic rate decline.

When this break would occur would likely depend on events in Washington. The longer rates stay at current levels the greater the structural damage to the economy. If economic performance continues to slide over the next few months, the Federal Reserve and the U.S. fiscal authorities will have little choice but to act to relieve the pressures created by the management of existing policies.

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Tourism and increased public spending expected to fuel modest recovery in Spain this year.

Spain, like most European economies remains in recession. GDP in 1981 grew by only 0.3% despite an expansionary fiscal policy and a 7% volume growth in exports. Private consumption, undermined by ever rising unemployment and more moderate wage settlements was the major source of weakness, declining by 1.8%. This year promises a modest improvement and the government is optimistically forecasting 2.5% growth. The ending of the severe drought should bolster agricultural output substantially and further strong performances are expected from public consumption and public investment. Consumer demand, however, will remain weak. The World Cup soccer matches in June and July should ensure a strong tourist season. But, a sustained recovery will require a rise in Spanish exports to Europe. Currently, this is being hindered by weak demand throughout Europe and by the peseta's present strength against other European currencies. Nevertheless, Spain's current-account deficit, which remained at $5 billion in 1981, should decline toward $3.5 billion in 1982.

Reduced oil revenues force budget revisions on Norwegian government.

The Norwegian government is still adjusting its forecasts to take account of substantially reduced oil revenues. The revised budget for 1982, just presented to Parliament, projects that adverse developments in the oil and shipping sectors will more than offset a reasonably buoyant domestic economy, resulting in a 1.5% decline in GNP. Amended forecasts revised the balance of trade surplus down to kr 13.7 billion (from the kr 18.1 billion earlier). And, thanks to large interest payments on overseas debt, the current account is now expected to show a much smaller surplus of only kr 1.3 billion (against kr 3.7 billion in earlier projections). To counterbalance the larger shortfall in government tax receipts anticipated as a result of the lower oil revenues, the new budget proposes to increase non-oil taxes—a difficult move for the Conservative government which has been commited to using the country's oil revenues to direct resources away from the public sector towards the private. Nonetheless, the government claims some success for its policies to date. In addition, it still hopes that its 1983 budget—to be prepared this autumn—will show further cuts in government expenditures coupled with offsetting cuts in personal income taxes.

Icelandic recession may bring improvements in inflation, trade deficit.

Iceland's economic slowdown appears to be turning into a full blown recession. According to the April report of the National Economic Institute, per capita GNP is expected to decline by 2% in 1982 after growth of only 0.2% last year. Contributing to the downturn are weak world demand for aluminum and ferrosilicon exports and a poor capelin catch that has depressed Iceland's fishing industry. Nevertheless, the recession is expected to be relatively short-lived, coming to an end sometime in 1983 as the reviving world economy sparks increased demand for Icelandic exports. Furthermore, the recession is expected to generate some positive effects: It is anticipated the trade deficit on goods and services will fall toward 4.5% of GNP, down from 5% last year. In addition, some easing of labor market pressures may give the country a chance to moderate wage settlements and help bring the rate of inflation down below 50% for the first time in three years.

Venezuelan authorities opt for prudent policies despite upcoming presidential elections.

The reversal in the world petroleum market has come at a politically inopportune time for Venezuela, in that 1983 is a presidential election year. Nevertheless, in the interest of avoiding a return to large fiscal deficits and balance-of-payments disequilibrium, the Herrera administration has apparently opted against stimulative economic measures in favor of a more cautious policy approach. According to official projections, this year's central government budget revenues will be some 13-14 billion bolivars ($3-3.3 billion) less than previously projected in light of the sharply lower oil export earnings. To cover the gap, the authorities are relying principally on a 10% reduction of current spending by all public entities, which, if successful, could reduce central government expenditures by some 8 billion bolivars ($1.9 billion). The remainder is to be financed by substantial gasoline price and airport exit tax increases, elimination of customs exemptions for state companies, and utilization of uncommitted Treasury reserves.

China may have achieved trade surplus last year.

In late April, the State Statistical Bureau in Beijing announced that China had achieved virtual trade balance in its foreign trade during 1981. Total exports increased 18% in real terms to approximately $21.6 billion (f.o.b. basis), while total imports rose 5% in real terms to a similar dollar level (c.i.f. basis). However, given the current reorganization of the foreign trade bureaucracy and the authority that has been decentralized for the most dynamic coastal provinces, the true status of China's foreign trade in 1981 remains uncertain. Western trade partner data suggest that China actually achieved a significant trade surplus last year. In its March-April issue, JETRO's *China Newsletter* published its preliminary estimate of a $2.44 billion trade surplus for 1981, with Chinese exports worth $22.4 billion. China's most buoyant export market in 1981 was the United States where sales rose nearly 80% to $1.9 billion, while U.S. exports to China actually fell 4% to $3.6 billion. China's official figures would imply that fourth-quarter imports approached the record level of $6.5 billion set in fourth-quarter 1980. Since already available OECD data fail to indicate a sizeable increase, such a surge could only have come from Hong Kong or elsewhere in Southeast Asia.

Korean current-account gap not likely to exceed target, despite markedly slower export growth.

The continued weakness of the world economy is having a serious impact on Korean export growth. In the first four months of this year, the annual rate of export growth slowed to 5.3% compared with a rate of 21% last year and an even higher rate throughout the 1970s. The government now faces a choice: It can either wait out the global recession and risk the potential political embarrassment that would result from a failure to meet its 1982 export target of $24.7 billion; or, it can adopt some sort of export stimulus measures—probably a further lowering of interest rates and a devaluation of the won—which may or may not prove to be effective. However, even in the event that exports do fall below target, there is little likelihood the current-account deficit will increase beyond the level planned, as the government is reluctant to increase external financing at currently high interest rates. Possible adjustments could come from the import side—either from slower economic growth or from specific policy measures designed to stem import growth.

Burmese economic boom accompanied by heavier debt burden.

After a long period of stagnation and decline, Burma has enjoyed a modest economic boom over the past several years, thanks to a "green revolution" in agriculture and large amounts of concessional aid. Real growth is estimated to have been 6%-6.5% for the fiscal year just ended in March, and over the past five years growth has averaged 6.4%. The country's improved economic performance has been accompanied, however, by a growing debt burden—the debt-service ratio, defined to include service receipts, now exceeds 20%. If the recent pace of growth is to be maintained, the Burmese government will have to take steps to boost its exports and to turn increasingly to sources other than loans—namely, domestic savings and foreign direct investment—to finance its development projects.

Foreign financing critical to Yemeni development plan.

The Yemen Arab Republic has recently launched its second five year development plan covering 1982-86. The ambitious program calls for a 7% annual growth rate to be generated by 29.3 billion riyal ($6.4 billion) of investment aimed at developing the country's currently meager domestic productive base. By increasing production of basic manufactures and agricultural commodities, the authorities hope to hold import growth to a mere 1% per annum in order to prevent the current-account deficit from deteriorating in real terms. Foreign financing totaling $3.4 billion will be required over the plan period, of which only $330 million is expected to be in the form of direct investment, mainly from Yemen's Arab allies. The balance, some $600 million a year must come from loans, although there are doubts as to whether amounts of this size will be available in the form of concessionary funding. If the plan is successfully implemented, however, the Yemeni population can expect to move another step away from their extreme poverty. Nevertheless, prospects for sustained economic prosperity over the longer run will depend on the success of current oil exploration efforts.

Distress Borrowing Cannot Last

The surge in short-term corporate borrowing so far this year has exceeded most observers' expectations. The levels of commercial and industrial bank loans and non-financial commercial paper outstanding have grown at an annual rate of nearly 23% since January. By normal standards this growth is unusual, given the weakness in the economy, the sizable inventory liquidations that have occurred, and the depressed state of corporate investment spending plans.

The special characteristic of this recession that accounts for the significant increase in credit demand is the highly leveraged nature of corporate balance sheets. Debt-to-total-asset ratios on a book value basis have risen from an average of less than one-third in the early 1970s to over one-half today. Much of this rise has come in the short maturities (less than one year), as firms have been reluctant to commit themselves to long-term debt obligations at existing high interest rates. These circumstances require them to refinance periodically at historically high interest rates, swelling the magnitude of their interest payments.

As profits and cash flow have deteriorated because of sagging consumer spending, these firms have found themselves in financial distress, needing to borrow an increasingly greater amount to finance their heavy interest commitments in order to avoid bankruptcy. Nevertheless, the extent to which the large volume of short-term borrowing in the first half of 1982 has been distress-related suggests that this trend cannot sustain itself indefinitely—whether or not the expected economic recovery materializes in the second half of the year. If the recovery does progress on schedule, cash flow will improve. This will enable firms to meet their interest obligations out of internally generated funds and perhaps retire some of their outstanding debt and rebuild liquidity. If, on the other hand, economic activity does not rebound, more over-leveraged firms will go bankrupt. By eliminating some of the heaviest borrowers, this development would also serve to slacken the pace of corporate credit demand—at least in the short run. Thus, regardless of the state of the economy, the demand for bank loans and commercial-paper borrowings should slow later in the year.

Another development that would reduce short-term credit demands, of course, would be a decline in long-term interest rates large enough to allow some funding out of the heavy short-term debt burden. As lower inflation figures are reported each month, this eventuality becomes more and more likely. Although it would not necessarily alter the total level of outstanding debt, it would serve to lengthen the maturity structure of this debt. This would mitigate the hectic refinancing activity that has been accelerating corporate credit demands.

Europe, Canada & U.S. Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	INDUSTRIAL OUTPUT		GNP IN 1980		BALANCE O				
		latest data	12-month change	in billions of dollars	real growth	latest data	reserves (less gold) in $ million	12-month change	months of imports covered	use o credit lions of
Austria	Economic growth of up to 2% expected this year—stronger than for rest of Europe.	Jan.	+7%	76.5	+3.1%	March	4,873	+ 9%	2.8	
Belgium	Inflation rise likely after Feb. devaluation, but small increase in real GNP expected for 1982.	Jan.	+4%	96.1*	+2.0%	March	3,985	—35%	0.8	
Britain	Economic upturn expected this year, although few signs of it have emerged so far.	March	0	523.5	—1.7%	March	14,430	—31%	1.6	2
Denmark	Growth prospects good but government plans to increase taxes from July 1st.	Feb.	—1%	64.7	—0.2%	March	2,102	—31%	1.4	
Finland	Pace of economic activity is beginning to slow.	Jan.	+2%	47.8*	+1.0%*	March	1,552	—13%	1.3	4
France	Recovery losing steam as surveys detect less business confidence regarding outlook.	Feb.	—2%	657.0	+1.6%	Feb.	20,560	—31%	2.0	
Germany	Industrial order volume still declining; economic institutes revise 1982 growth forecast down to 0.5%.	March	0	689.4*	—0.3%*	March	41,174	—18%	3.0	
Greece	Real investment likely to fall sharply for third year in a row despite expected small upturn in GNP.	Dec.	—2%	41.8	+1.6%	Jan.	633	—41%	0.8	
Ireland	Feb. industrial production showed sharp upturn to 7.9% above level of year earlier.	Dec.	+9%	17.6	+1.9%	March	2,394	— 3%	2.7	
Italy	Economy recovered somewhat at year-end 1981, but leading indicators fail to indicate sustained upturn.	March	—2%	394.9	+4.0%	March	14,765	—18%	1.9	
Netherlands	Coalition splits on issue of spending cuts; minority government or new elections possible.	March	—2%	167.4	+1.0%	March	9,287	—15%	1.7	
Norway	Falling oil production and weak shipping sector will result in GNP fall of some 1.5%.	Feb.	+2%	55.4	+2.6%	March	6,065	+15%	4.4	
Portugal	Upward price pressures growing; year-on-year inflation rate was 27.1% in March.	Oct.	+1%	23.5	—5.5%	Feb.	382	—31%	0.5	4
Spain	Expansionary budget and end of drought should ensure modest growth in 1982.	Nov.	—1%	211.1*	+1.2%	Feb.	10,140	—10%	3.9	1
Sweden	April's revised national budget predicts a 1.4% rise in GDP this year.	Feb.	0	122.9	+1.4%	March	3,412	—18%	1.4	
Switzerland	Marked weakness in foreign orders confirms overall picture of economic slowdown.	Dec.	+3%**	97.8*	+3.9%	March	12,512	— 3%	4.7	
Canada	Unemployment rate reaches a record 9.6% in April as industrial production declines.	Feb.	—8%	274*	+3.0%*	April	2,717	+20%	0.4	
United States	Recession shows signs of lingering as interest rates have remained high.	April	—7%	2,925.5*	+2.0%*	March	18,800	— 2%	0.9	

*1981 **4th quarter average over 4th quarter average †GDP

Grappling With the Budget

As Congress and the president attempt to zero in on a compromise on the federal budget, they appear to be caught between economic reality and election-year politics. A steeper-than-expected recession has worsened the outlook since President Reagan introduced his budget proposals in February. Thus, the administration has been forced to increase the size of proposed "deficit-reducing measures" to hold the fiscal 1983 deficit near the $100-billion level. The unpleasant truth that the budget writers face is that any action to reduce the deficits carries with it the potential for reducing some constituents' spendable incomes. Thus, any stimulative effects that might derive from a smaller deficit—chiefly, it is hoped, through lower interest rates—may well be offset by reductions in purchasing power.

As recently as two months ago, there were assertions that the administration was overstating the fiscal 1982 deficit in an effort to draw out the more frugal instincts of House and Senate budget committee members. The basis for these claims was that, while projections had placed the deficit at around $100 billion, the cumulative deficit through February was actually running some $2 billion behind the deficit for the comparable period in fiscal 1981, when the deficit for the year had totaled only $58 billion. This "deficit shortfall" proved to be temporary, however. The rapid growth in tax receipts that had helped bring it about—spurred by a hike in the interest rate charged on late tax payments to 20% from 12%—has slowed markedly. By March the deficit was about $9 billion above the year-earlier level. Prospects of similar wide gaps in April and May have renewed expectations of a $100-billion deficit for fiscal 1982.

In the current negotiations on the fiscal 1983 budget, the "baseline" deficit that would occur without any further congressional action is estimated at $182 billion. To bring the deficit down to the $100-billion level would require about $80 billion of either revenue increases or spending cuts. The budget writers thus far have agreed to modest cuts in nondefense, non-entitlement spending, and to a $5-billion scaling back of the increase in the defense budget approved last year. Some saving is also expected from lower financing costs that would result from a smaller deficit. In addition, congressional budget committee members are counting on highly uncertain proposed presidential actions that would bring an additional $20 billion into the federal coffers from such measures as increased user fees and sales of government assets. And there appears to be a consensus that taxes will have to be raised by some $25-30 billion.

The particulars of both the spending cuts and the tax increases, however, will be difficult to achieve, given the pressures of different constituencies. The longer the budget outlook remains clouded, the more likely it is that the credit markets will continue to demand an interest premium for this uncertainty—which could delay the recovery and up the likely size of the deficit.

F PAYMENTS		MONEY AND BANKING							COUNTRIES
		12-month changes							
IMF mil-dollars	current influences on payments	latest data	consumer prices	latest data	money supply(M1)	central bank rate	exchange rate in U.S. dollars May 19, 1982	current monetary conditions	
0	Export orders strong, current account in surplus during first quarter of 1982.	March	— 6%	Feb.	— 3%	6.75%	.0612	Interest rates follow German rates.	Austria
0	Loosening of wage indexation will increase export competitiveness.	March	+ 8%	Dec.	+ 2%	14.00%	.0228	Belgium franc continues to suffer from speculative attacks.	Belgium
8	Latest figures show current-account surplus of $10 billion at annual rate.	March	+ 11%	Feb.	+ 16%	13.06%	1.7870	Rates down slightly despite Falkland Islands uncertainty.	Britain
0	Current-account deficit of kr. 13 billion expected for 1982.	Feb.	+ 12%	Dec.	+ 12%	11.00%	.1269	Interest rates kept high by devaluation rumors.	Denmark
5	Current-account surplus was fmk 1.2 bn. in first quarter, vs. 95 mn. year ago.	March	+ 10%	Nov.	+ 17%	9.25%	.2207	After some easing, central bank raised reserve requirements.	Finland
0	Current-account deficit of around ff 50 billion expected in 1982.	April	+ 14%	Dec.	+ 16%	9.50%	.1650	Expected EMS adjustment keeps interest rates high.	France
0	Current-account surplus now widely forecast for 1982.	April	+ 5%	Jan.	— 1%	7.50%	.4306	Bundesbank abolishes Special Lombard Rate.	Germany
7	Current account in 1981 failed to improve despite small decline in real GNP.	Feb.	+ 20%	Nov.	+ 24%	20.50%	.0162	Monetary policy being eased.	Greece
0	First quarter current-account deficit 548 million pounds.	Feb.	+ 19%	Feb.	+ 6%	18.50%	1.4950	Interest rates remain at 20%; budget deficit persists.	Ireland
0	First quarter trade deficit rose to lit. 5.5 trillion, from lit. 4.9 trillion year earlier.	April	+ 16%	Nov.	+ 7%	19.00%	.000776	Money continues tight.	Italy
0	Current account remains in healthy surplus.	April	+ 7%	Jan.	+ 1%	8.00%	.3880	Government crisis leads to higher interest rates.	Netherlands
0	Healthy trade surplus of kr. 13.7 billion expected in 1982.	March	+ 12%	Dec.	+ 15%	9.00%	.1670	Credit policies remain restrictive.	Norway
0	Exports weak, but drought end should reduce food and electricity imports.	Jan.	+ 24%	Nov.	+ 14%	18.00%	.0140	Interest rates raised in attempt to curb credit demand.	Portugal
4	Current-account deficit forecast to fall to $3.5 bn. in 1982, vs. 1981's $5 bn.	Feb.	+ 15%	Dec.	+ 13%	8.00%	.00969	M3 growth target of 16% implies slight policy easing.	Spain
0	Debt service will keep current account deficit near kr. 14 bn. vs. 81's kr. 16 bn.	March	— 9%	n. a.	n. a.	10.00%	.1718	Despite slight easing monetary conditions remain tight.	Sweden
0	Loss of export competitiveness may further curtail current-account strength.	April	+ 6%	Jan.	+ 11%	5.50%	.5053	Rates down sharply as central bank boosts liquidity.	Switzerland
0	Falling import demand produces trade surplus.	March	+ 12%	April	— 2%	15.41%	.8086	Interest rates stay at high levels.	Canada
0	Continuing global slowdown affecting U.S. export growth.	March	— 7%	April	+ 5%	12.00%	—	Business borrowing robust as economy remains weak.	United States

most recently reported

World Interest Rates

market rates as of May 19, 1982; bond yields as of May 14, 1982

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	12.00	15.41	13.06 intervention rate	14.00	9.50	7.50	19.00 penalty rate 22.00	8.00	5.50	5.50
Day-to-Day Money	14.375 May 20	15.25	13.50	13.00	16.375	9.50	20.50	8.875	3.25 1-month Euro-Swiss fr. rate	7.1875
Treasury Bills 91-day, Middle Rates	11.86 discount basis	15.25	12.813	15.00	n. a.	n. a.	19.05 87 days	no dealing	no market	5.625 two-month
Commercial Paper prime, 3 month, asked	13.50 finance paper, discount basis	15.55 finance paper, 15% tax w. h.	12.184	13.90 Certificat	16.313 Interbank	no market	no market	no market	no market	mid (asked)
Bankers' Acceptances 3 month, asked	13.75	15.65 15% tax w. h.	12.813	13.90 Certificat	not traded	9.40	21.80	no market	3.938	no market
Government Bonds Long term, new and old issues, average yield	13.31	14.70	13.24	10.722 15% tax w. h.	15.55	8.77	20.81	10.05	4.86	7.13
Industrial Bonds prime, long term, new and old issues, average yield	14.60 Aa Industrials	16.70	14.50	14.324	16.83	8.80	20.69	11.04	5.95	6.63
Bank Short-Term Rate to Best Borrowers (prime rate)	16.50	17.00	14.00	17.00	18.50	12.50	21.75 1/4 differential on outstanding	10.50	9.50	6.00
Bank Time Deposits 3 month	14.875 Cert. of Dep.	15.60	13.563	14.60	16.313	8.90	11.50	9.00 large deposits	2.50 residents only	3.75 20% tax w. h.
Eurocurrencies 3-month, asked	14.8125	15.875	13.625	no market	27.50	8.813	no market	8.938	3.813	7.125
Exchange Rates—in U.S.$ rates floating against the $	—	.8086	1.7870	.0228	.1650	.4306	.000776	.3880	.5053	.00418
Forward Exchange Cover 3 month, in percent p.a. *D* = discount, *P* = premium	—	1.039 *D*	1.509 *P*	1.680 *D*	10.863 *D*	6.020 *P*	9.254 *D*	5.767 *P*	11.072 *P*	7.800 *P*

Eurodollar Deposits
(London, interbank, bid)
May 20

7-day	15.00
1-month	14.875
3-month	14.625
6-month	14.625

International Arbitrage
(3-month, hedged) + in favor of U.S. dollars

U.S.-U.K. Treasury Bills	−2.285
U.S.-Canada Treasury Bills	−1.591
U.S.-Canada Finance Co. Paper	− .798
Eurodollars-U.K. Local Auth. Deposits	+ .0535

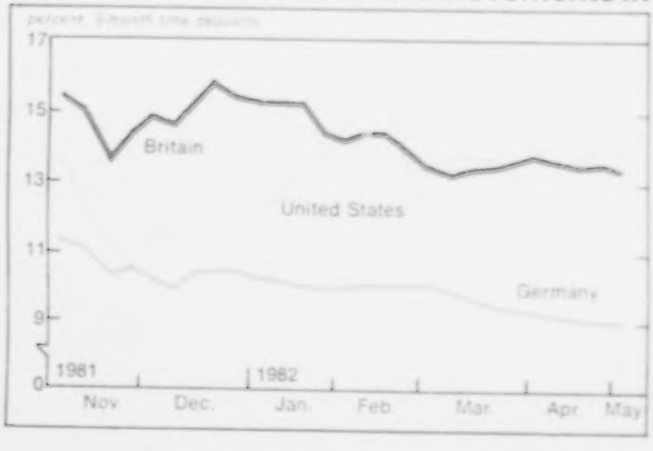
Eurobonds
(average yield on recent straight debt issues)

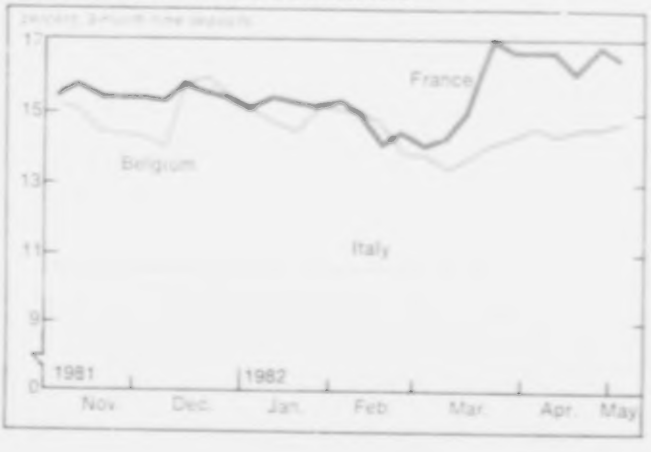
U.S. Dollar Bonds	
7 yrs. and under	14.125
Over 7 yrs.	14.375
DM Bonds	
7 yrs. and under	8.375
Over 7 yrs.	8.6875

Gold Price
London afternoon fixing
342.00
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Loan Term Rate To Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Interest-rate movements in selected industrial countries





Some Fallout From the World Recession

The worldwide recovery is on its way but in no hurry to get here. The few signs of an upturn that are beginning to emerge suggest a revival that is likely to be painfully slow. Consensus world economic growth projections for 1982 have been reduced significantly from earlier forecasts, and there is substantial likelihood that even this revised outlook is overly optimistic. The extensiveness of the global decline in output over the past year and the uncertainty generated by volatile interest rates and foreign exchange markets have continued to test government policies and strain the viability of international institutions. It is quite possible that problems have been created that may not disappear immediately with the recession's end.

A sluggish recovery will undoubtedly compound pressures for more expansionary monetary and fiscal policies and increased protectionist measures. Already, Germany has been called upon to act as a "locomotive" and pull its European neighbors out of the recession. And the United States repeatedly has been chastised by many of its trading partners for everything from high interest rates to poor fiscal management. Within the current institutional framework, however, there are limits to what policymakers can do without abandoning their stated longer-term goal of achieving sustained recovery without inflation.

Policy constraints and the recession

One of the primary causes of the recession—and a principal obstacle to a more robust recovery—has been the behavior of U.S. monetary aggregates and interest rates. Unprecedented volatility in money growth and interest rates, ignited by the Federal Reserve's change in operating strategy in October 1979, touched off the recession in the United States. The downturn has been transmitted to other economies via integrated international financial and goods markets. The worldwide slump has been perpetuated by the persistently high level of U.S. real interest rates, as monetary authorities in other countries have refrained from enacting more stimulative monetary policies for fear of encouraging an outflow of reserves and/or a depreciation of their currencies. Members of the European community have found this situation particularly troublesome, given the confines of the EMS.

In general, a group of countries wishing to maintain a system of fixed exchange rates must implicitly accept a common monetary policy. For example, if one country pegs its currency to another but is printing money twice as fast, its monetary reserves will flow out through either a deficit on the trade account, a deficit on the capital account, or both. Eventually, the country running the more expansionary monetary policy will be left without reserves and will have to devalue. At the same time, as prices are being arbitraged, the more expansionary monetary policy results in the higher inflation then consistent with devaluation.

In the case of the EMS, Germany cast its lot with the United States in the fight against inflation—partly because of the importance German policymakers placed on maintaining the value of the mark relative to the dollar. France, on the other hand—along with Belgium and Italy—has tended to move toward a more expansionary, higher-inflation path. As a result, in order to maintain its low-inflation policy, Germany must continue to tolerate a weakening French franc—largely negating the usefulness of the EMS as it is presently structured.

The short-run volatility of U.S. interest rates—attributable to the current operating tactics of the Fed—has made the German position vis-a-vis the French even less tenable within the EMS framework. The French government's intransigence with respect to its expansionary policies placed Germany in the position of either choosing higher inflation or accepting U.S. policy decisions. By opting for the latter, the Germans accepted a certain amount of U.S. financial market volatility as well as higher unemployment over the near term.

The same fate has befallen other countries that have chosen not to ignore the value of the dollar. Exchange rates have not been as flexible as might have been expected, given all the stated differences in individual country policies. The policies actually followed by most countries have been reasonably consistent with those of the United States, and with them have come some of the problems as well as the benefits deriving from Fed policy.

Even the Japanese have not been immune to recent policy shocks. Much to the surprise of many forecasters, the yen has remained weak in spite of Japan's strong current account. With the liberalization of its capital market controls, Japan is now exposed to the same set of international money-market constraints that other industrial nations face.

Unemployment and policy pressures

The pervasive problems brought on by U.S. monetary policies have compounded the strains of the slowdown in world trade that stemmed from the oil price shocks of the late 1970s and the decline in U.S. economic activity. As a result, unemployment in the industrialized nations has risen close to the post-war high, eliciting stepped-up demands for protectionist measures. To erect greater barriers to trade, of course, would merely extend the life of the recession and

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diminish the potential for recovery once it begins. Moreover, policymakers would do well to remember that such protectionist activities were partly responsible for turning the 1929 recession into the Great Depression. Nevertheless, the pressures in support of such economic provincialism are likely to continue as long as growth is lackluster and unemployment remains high. The trade reciprocity issues currently under discussion must be carefully addressed, in that there is a danger that reciprocity could become "protectionism in the name of free trade." To avoid giving in to protectionist sentiments, the policymakers of the major trading nations must be mindful of already existing nontariff barriers to trade.

Along with the increased protectionist demands have come demands that the United States should change its policies and bear the brunt of the recession it brought about. To be sure, while some displacement of production has been inevitable with the disinflation process, the persistence of high and volatile interest rates—contributing to the prolonged recession in the United States—is primarily the responsibility of the Federal Reserve. However, there are, at present, limits to what the Fed can do about this.

Given the low level of credibility inherited by the Fed from the pro-inflation policies of the 1960s and 1970s, the flexibility of the central bank within its current operating strategy is severely constrained. A move to bring down U.S. interest rates by abandoning the targets set for the growth of the monetary aggregates would be a signal to the market that the recent gains in reducing inflation are likely to be temporary, lasting only until the recession is over. With its skepticism about Fed policy then confirmed, the market would act to push interest rates even higher, which could lead to significant weakening of the dollar and a worldwide rekindling of the inflationary environment of the 1970s. All in all, the Fed has painted itself into a corner from which it cannot easily retreat. It must adhere to its aggregates-targeting policies, but at the same time it must find some way of improving its short-run operating procedures in order to minimize the inevitable strains of a sluggish recovery.

Coping with volatility

Despite the disquieting results of short-run policy actions and the disappointing prospects for economic activity in the near term, there are a number of encouraging signs for the longer run. For one thing, worldwide markets are learning how to cope with erratic monetary policy and volatile interest rates. With the increased use of new risk-sharing instruments, such as financial futures and options, corporations are learning to live with interest-rate volatility in the 1980s just as they learned to live with exchange-rate volatility during the 1970s. As the markets for these new instruments become more mature, they will effectively become the private sector's insurance against public-sector policy shocks. Another promising sign is that some progress is being made in bringing government spending under control. However, the battle is far from won in the United States, or in Germany and the rest of Europe. Finally, and, perhaps most important, the disinflation process is under way and moving faster than anyone had thought possible.

All of these advances will translate into lower inflation expectations and lower interest rates over the next year. If additional progress is made in reducing U.S. federal spending and if the Federal Reserve can get its short-run aggregates policy under control, the elements will be in place for a strong, low-inflation recovery in the United States. The stage would then be set for a recovery without inflation abroad. A concerted effort by the industrialized nations to solve, once and for all, the key problems of inflation expectations would go a long way toward reordering the structure of world production to achieve higher per-capita output. And this, in turn, would lead to a greater real rate of return on savings and investment worldwide, not to mention a more stable commodities market.

The crucial question over the next several months will be whether the policymakers of the western economies will be able to resist pressures for nationalistically motivated action—action that could preclude a sustained worldwide expansion in 1983 and beyond.

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